



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PQA 720.7.810

June 25, 2002
02-PQA-050(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance for *Nonmajor* Contractor Audits with Maximum Control Risk Assessments and Audit Evidence Highly Dependent on Contractor Computerized Information Systems

A. Summary

Beginning with the July 2002 APPS, the APPS working papers retrieved for *nonmajor* contractor audits using DCAA's *Internal Control Questionnaire* will include a new preliminary audit program step in standard working paper B-1 (W/P B-1) and a new section in standard working paper B-2 (W/P B-2) to help document completion of the step. The new step prompts the auditor to document the audit work performed that supports reliance on significant amounts of evidential matter generated from the contractor's computer-based systems. If the contractor's controls related to these systems have not been adequately tested in other audits, the auditor needs to either (1) develop, document, and reference in B-2 the procedures/tests in this audit that will support reliance on the evidential matter or (2) qualify the audit in accordance with CAM 10-210.4a and 10-504.4a.

B. Background

Over the last several years, the GAO has become increasingly concerned over whether auditors assessing control risk at maximum AND relying on significant amounts of computer generated data from the audited entity were actually gathering sufficient, competent, and relevant evidence to support the level of reliance placed on that data.

- In May 1999, the GAO issued Amendment No. 1 to the 1994 version of the "Yellow Book," which revises chapter 4, *Field Work Standards for Financial Audits*. The Chapter 4 revision establishes a new field work standard requiring specific working paper documentation when control risk is assessed at the maximum level and the assertions of the audited entity (e.g., contractor proposals and submissions) are significantly dependent on computerized information systems. The Comptroller General's foreword to the revision states, "[R]equiring auditors to document their basis for assessing control risk at maximum and the planned audit procedures that relate to that decision will help ensure that auditors do not inadvertently rely on computer-generated evidence in conducting substantive testing."

For major contractors, testing of computerized information systems is accomplished through the execution of our systems audits. For nonmajors, we often assess control risk at the maximum because we have not tested and we do not rely on the contractor's system of internal controls.

C. Guidance

Auditors initiating DCAA audits of *nonmajor* contractors are prompted by the APPS to first identify that the audited entity is a *nonmajor* contractor and then to indicate the applicability of either (1) a DCAA *Internal Control Questionnaire* (the norm) or (2) DCAA's internal control (ICAPS) audits (the exception). Beginning with the July 2002 APPS, when both *nonmajor* contractor and *Internal Control Questionnaire* (ICQ) are indicated, the APPS working papers retrieved for the audit assignment will include a new preliminary audit program step in standard working paper B-1 (W/P B-1) and a new section in standard working paper B-2 (W/P B-2) to help document completion of the step.

1. New Preliminary Audit Program Step. While the wording of the new preliminary audit program step will be tailored to suit the particular *nonmajor* contractor audit assignment being performed, the step will consistently prompt the auditor to do the following:

If the evidential matter to be obtained during the audit is highly dependent on computerized information systems, document the audit work performed that supports reliance on the computer-based evidential matter. If the contractor's controls related to these systems have not been specifically/adequately tested in other audits, the auditor needs to either (1) develop, document, and reference in B-2 the procedures/tests in this audit that will support reliance on the evidential matter or (2) qualify the audit in accordance with CAM 10-210.4a and 10-504.4a.

2. New W/P B-2 Section (to document completion of the preliminary audit program step).

Is the contractor's submission supported by data from computer-based systems on which you will significantly rely to reach your conclusions?

Yes			No	
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If yes, (1) reference below where the reliability of the data was sufficiently established in other DCAA audits (e.g., floorchecks or incurred cost audits) or by other non-DCAA auditors (CAM 4-1000) or (2) reference below and incorporate in the "Scope of Audit" W/P B section the procedures being performed in this audit to obtain evidence about the reliability of the data (e.g., directly testing the data to source documents; review computer reports for completeness, obvious errors and reasonableness of amounts; and confirming computer-processed data with product users). If reliability of the computer based data cannot be sufficiently determined by completing (1) or (2) above, the audit report should be qualified in accordance with CAM 10-210.4.

3. Completing the New W/P B-2 Section. Most DCAA audits of *nonmajor* contractors involve contractor submissions supported by substantial amounts of computer processed data upon which the auditor will significantly rely to reach his/her conclusions. In some cases, the reliability of the data may have been sufficiently established in other DCAA audits, and all the auditor needs to do is document this in the new W/P B-2 section provided (see *Example 3* in the Enclosure). In other cases, the auditor may choose to include procedures in the instant audit specifically designed to provide

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reasonable assurance related to the reliability of the computer processed data (see *Example 2* in the Enclosure). Often, we think that a combination of both approaches will provide the documentation and assurance that is sought by the new GAGAS requirement (see *Example 1* in the Enclosure). We also believe that both approaches (or combination thereof) will represent the majority of audit situations involving *nonmajor* contractors that DCAA auditors will encounter.

4. Qualifying the Audit Results & Report. Should the auditor determine during the risk assessment process that neither alternative in section 3 above is suitable to performing an efficient and timely audit, then he or she must adopt the third approach noted in the introductory guidance to new W/P B-2. The approach calls for qualifying the audit results and audit report in accordance with CAM 10-210.4. Example pro forma language for this qualification (with additional options in *italics*) is presented below.

To achieve the planned audit objectives [*or, planned objectives for the audit*], we relied extensively on information processed through the contractor's computerized systems [*or, name specific system(s)*]. [*Due to*] We did not perform sufficient audit procedures to determine with reasonable assurance the reliability of the computer-processed information. Therefore, our audit results [*pertaining to ...*] are qualified to the extent that they could be significantly impacted by the performance of such procedures.

As directed in CAM 10-210.4, DCAA audit report qualifications are to be included in the *Scope of Audit* section of the report under the separate subheading "Qualifications." When one or more qualifications are included in the *Scope of Audit* section, the auditor must also qualify the audit opinion paragraph (i.e., use words like "In our opinion, except for the qualification in the Scope of Audit section above, ...").

D. Concluding Remarks

Please direct any questions or concerns you may have to your regional office. Regional offices may address their questions to Mr. Ken Saccoccia, Program Manager, Quality Assurance Division (PQA) at 703-767-2250 or e-mail address, dcaa-pqa@dcaa.mil.

/Signed/
Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

Enclosure:

Completed Examples of New W/P B-2 Section

DISTRIBUTION: C

Completed Examples of New W/P B-2 Section

Below are three completed examples of the new W/P B-2 section developed for dealing with the new GAGAS in the preceding audit guidance memorandum. The new GAGAS generally calls for DCAA's *nonmajor* contractor auditors to document their determinations of the reliability of information processed through contractor computer systems. We completed the examples based on made up *ABC Company* data. We are providing the examples so that auditors can better gage the type and extent of documentation needed to satisfy the new GAGAS. Auditors should *consider* the preceding guidance and examples below when completing the new W/P B-2 section in actual audit situations. As always, however, DCAA's auditors are expected to apply their own judgment when documenting their actual audit situations.

A. Assumptions.

1. You are auditing ABC Company's FY 2000 incurred cost submission.
2. ADV for CFY 2000 was \$1.2 million. ABC has 1 CPFF contract and one FFP contract.
3. 70% of the ADV (\$840k) is direct & indirect labor and labor fringe benefit costs; 13% of the ADV is direct & indirect travel (\$156k); and the remaining ADV (\$204k) represents office rent, computer processing costs, supplies, and other miscellaneous costs.
4. There were 12 employees on the payroll for most of the year. All charged their time to both direct and indirect labor cost accounts/job orders. Half of the time was charged to the CPFF contract and half to the FFP contract.
5. In early CFY 2000, FAO auditor, Ms. Tifi, audited the ABC price proposal that led to the FFP contract award. During this audit, Ms. Tifi also performed a MAAR 6 labor floorcheck review (2000X1031001) sufficient in scope to reasonably validate the (1) existence of ABC's employees, (2) reasonableness of their pay rates, (3) accuracy of their pay computations, and (4) hours that the employees entered into ABC's *Beltech* computerized labor accounting system against those distributed to the two contracts.
6. ABC's labor adjustments after initial entry are relatively significant.
7. ABC's submission reconciles to the *Beltech Summary Contract Ledger Report*.
8. Last year's incurred cost audit questioned \$18,000 charged to the travel account.
9. The information above and in the two bullets below has been adequately documented/referenced in the standard APPS "B" working papers.
 - We will test a few of the manual entries on ABC's Form 99 authorizing the adjustments to both the Labor Adjustment Report and contract cost ledgers and vice versa. (WP C)
 - Our cursory review of the *Beltech Travel Cost Report* (TCR) shows that 50% of the travel costs were attributed to Mr. Pie, ABC's CEO & Chief Engineer. Since last year's CQ was also attributed to Mr. Pie, we will test a few entries from the TCR to Mr. Pie's travel claim documentation and contract cost ledgers and vice versa. (WP D)

Completed Examples of New W/P B-2 Section

B. Example 1 of New WP B – Reflecting Auditor Reliance on Both Prior Work and Current Procedures

Is the contractor's submission supported by data from computer-based systems on which you will significantly rely to reach your conclusions?

Yes	X		No	
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If yes, (1) reference below where the reliability of the data was sufficiently established in other DCAA audits (e.g., floorchecks or incurred cost audits) or by other non-DCAA auditors (CAM 4-1000) or (2) reference below and incorporate in the "Scope of Audit" W/P B section the procedures being performed in this audit to obtain evidence about the reliability of the data (e.g., directly testing the data to source documents; review computer reports for completeness, obvious errors and reasonableness of amounts; and confirming computer-processed data with product users). If reliability of the computer based data cannot be sufficiently determined by completing (1) or (2) above, the audit report should be qualified in accordance with CAM 10-210.4.

Our audit plan reasonably assures the reliability of the information processed through ABC's *Beltech* accounting system. Except for ABC's post-entry labor adjustments, we determined the reliability of ABC's FY 2000 labor cost information in our *Labor Floor-check* assignment, 2000X1031001. We will assure the reliability of the *Beltech Labor Adjustment Report* (LAR) and *Beltech Travel Cost Report* (TCR) with our tests noted in W/P B, section 6. The other costs in ABC's submission are not individually significant; nevertheless, from completing our preliminary audit steps (B-1), we determined that the costs in total tied into ABC's *Beltech Summary Contract Ledger Report* (SCLR) and that the SCLR amounts were generally complete, free of obvious errors, and reasonable.

C. Example 2 – Reflecting Auditor Reliance on Current Procedures Only. For this example all of the Assumptions in A apply except that:

- the FY 2000 floorcheck review was *NOT* sufficient in scope to reasonably validate the (1) reasonableness of pay rates, (2) accuracy of pay computations, and (3) hours that the employees entered into ABC's *Beltech* labor accounting system against those distributed to the two contracts; and
- the standard APPS "B" working papers will outline/provide reference to the audit procedures and tests planned in the *Example 2* audit to accomplish objectives (1) through (3) above.

Completed Examples of New W/P B-2 Section

Is the contractor's submission supported by data from computer-based systems on which you will significantly rely to reach your conclusions?

Yes	X		No	
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If yes, (1) reference below where the reliability of the data was sufficiently established in other DCAA audits (e.g, floorchecks or incurred cost audits) or by other non-DCAA auditors (CAM 4-1000) or (2) reference below and incorporate in the "Scope of Audit" W/P B section the procedures being performed in this audit to obtain evidence about the reliability of the data (e.g., directly testing the data to source documents; review computer reports for completeness, obvious errors and reasonableness of amounts; and confirming computer-processed data with product users). If reliability of the computer based data cannot be sufficiently determined by completing (1) or (2) above, the audit report should be qualified in accordance with CAM 10-210.4.

Our audit plan reasonably assures the reliability of the information processed through ABC's *Beltech* accounting system. We will determine the validity of ABC's FY 2000 labor costs and associated *Beltech* reports, including ABC's post-entry labor adjustments and *TCR Report*, in the tests planned for this audit (see W/P B, section 6). Similarly planned tests (W/P B, section 6) will also assure the reliability of the *Beltech Travel Cost Report* (TCR). The other costs in ABC's submission are not individually significant; nevertheless, from completing our preliminary audit steps (B-1), we determined that the costs in total tied into ABC's *Beltech Summary Contract Ledger Report* (SCLR) and that the SCLR amounts were generally complete, free of obvious errors, and reasonable.

D. Example 3 – Reflecting Auditor Reliance on Prior Work Only. For this example all of the Assumptions in A apply except that:

- ABC's labor adjustments after initial entry are *NOT* that significant and/or were sufficiently reviewed in the *Labor Floorcheck* assignment.
- ABC provided Ms. Tifi with a revised submission prior to the audit entrance conference reflecting the fact that Mr. Pie, Jr., ABC's CFO, had mistakenly posted an extra zero for the CPFF contract ODC travel when developing the initial submission (a *Microsoft EXCEL* document based on ABC's *Beltech* system output.) The ODC & indirect travel costs now allocable to the CPFF contract are \$80,000.

Is the contractor's submission supported by data from computer-based systems on which you will significantly rely to reach your conclusions?

Yes	X		No	
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Completed Examples of New W/P B-2 Section

If yes, (1) reference below where the reliability of the data was sufficiently established in other DCAA audits (e.g, floorchecks or incurred cost audits) or by other non-DCAA auditors (CAM 4-1000) or (2) reference below and incorporate in the "Scope of Audit" W/P B section the procedures being performed in this audit to obtain evidence about the reliability of the data (e.g., directly testing the data to source documents; review computer reports for completeness, obvious errors and reasonableness of amounts; and confirming computer-processed data with product users). If reliability of the computer based data cannot be sufficiently determined by completing (1) or (2) above, the audit report should be qualified in accordance with CAM 10-210.4.

Our audit plan reasonably assures the reliability of the information processed through ABC's *Beltech* accounting system. We sufficiently determined the reliability of ABC's FY 2000 labor cost information in our *Labor Floor-check* assignment, 2000X1031001. The other costs in ABC's submission are not individually significant; nevertheless, from completing our preliminary audit steps (B-1), we determined that the costs in total tied into ABC's *Beltech Summary Contract Ledger Report* (SCLR) and that the SCLR amounts were generally complete, free of obvious errors, and reasonable.